

THEORETICAL REVIEW OF ANALYSIS OF CAPITAL STRUCTURE AND FIRMS PERFORMANCES

Babalola Yisau Abiodun^{*}

1. Introduction

Analyses of financing decisions are one of the most critical areas for accountants and finance managers. It has direct impact on capital structure and financial performance of the companies Gupta, Srivastata and Sharma (2007). For examining the analyses of capital structure practices, capital structure ratios have been used. It is useful for the creditors to know the liquidity position of the firm. Ratio like proprietary ratio, fixed assets turnover ratio etc., are likely to manifest all the major dimensions of the capital structure practices of the company as against only the debt-equity ratio.

Given the nature and purpose which it pursues, financial analysis develops the steps of collecting, shaping and treatment of a range of management information which may clarify the wanted diagnosis and prognosis. Information handled by the financial analysis is given traditionally, by general accounting, which led to the misnomer of “accounting analysis”. However, recent evolution led to considerable expansion of information sources handled by the financial analysis, which is profoundly renewed Ungureanu, (2013).

Capital structure is the mix of the long-term sources of funds used by the enterprises. It involves how an enterprise finances its operations in terms of debt and Equity combination with four basic elements namely; ordinary shares, preference shares, debenture and retained earnings. Generally, an enterprise can go for different levels/mixes of debts, equity or other financial arrangement. It can combine bonds, lease financing, bank loans or many other options with equity in an overall attempt to boost the market value of an enterprise. Both theoretical and empirical capital structure studies have generated many results that attempt to explain the analysis of financial structure.

2. Conceptual Measurement and Methodological Framework

Accounting analysis is premised on the attainment of accounting information for decision making. Financial accounting information can be defined as “the product of corporate accounting and external reporting systems that measure and publicly disclose audited, quantitative data concerning the financial position and performance of publicly held firms” Bushman and Smith (2001).

Thus, financial accounting is the fundamental source of independently certified information about the performance of the executives. Indeed, financial accounting systems provide valuable information to corporate control mechanisms that help to alleviate the agency problem which results from the separation of managers and financiers as well as the shareholders.

Financial accounting information can be defined as “the product of corporate accounting and external reporting systems that measure and publicly disclose audited, quantitative data concerning the financial position and performance of publicly held firms”. Thus, financial accounting is the fundamental source of independently certified information about the performance of executives. Indeed, financial accounting systems provide valuable information to corporate control mechanisms

^{*} © Babalola Yisau Abiodun; PhD student; Accounting and Auditing Department; Odessa National Economics University; Odessa; Ukraine.

that help to alleviate the agency problem which results from the separation of managers and financiers as well as the shareholders. The use of accounting information in corporate governance mechanisms can be explicit (direct) or implicit (indirect). Financial accounting information is explicitly used in managerial incentive contracts or debt contracts (direct use), but also contributes to the information contained in stock prices (indirect use). Furthermore, financial accounting information is both an output of the governance process, since it is produced by managers, and also an input since it is used in corporate control mechanisms. This is shown explicitly on Fig. 1 below.

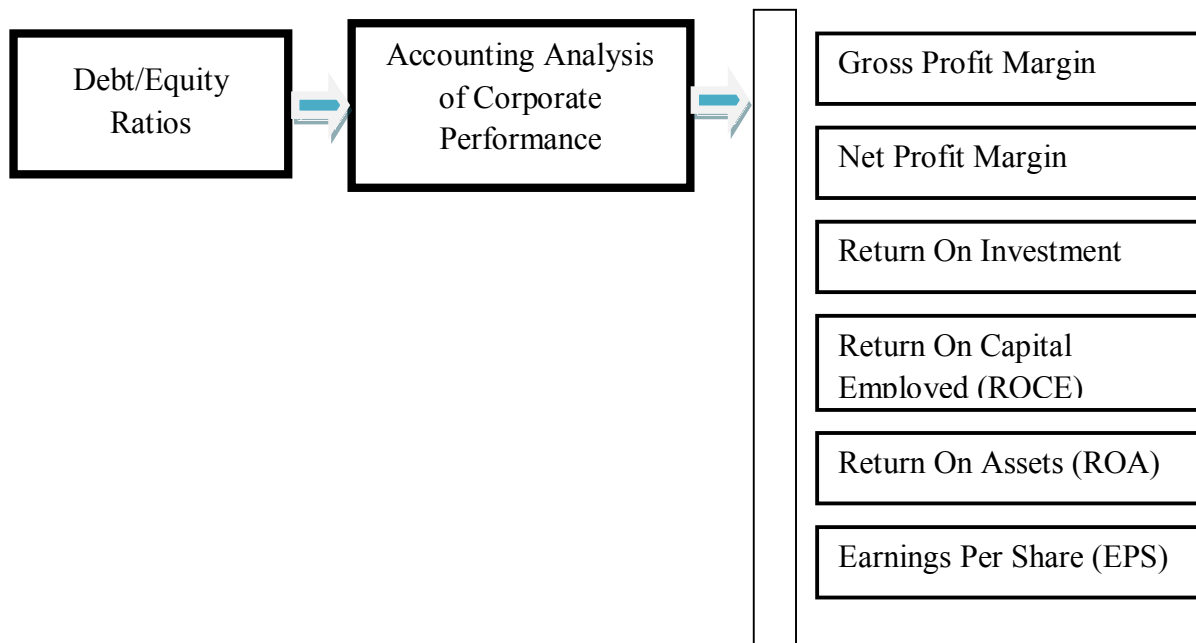


Fig. 1. Conceptual Framework of Accounting Analyses of Capital Structure and Corporate Performance of Firms

As demonstrated in figure 1 above, performance measurement systems were developed as a means of monitoring and maintaining organizational control, which is the process of ensuring that an organization aims at strategies that lead to the achievement of its overall goals and objectives.

Accounting cum financial measures, the key tools for performance measurement systems, play a vital role in every organization as they are often viewed as forward-looking indicators that assist management to predict a company's economic performance and many times reveal the need for possible changes in operations.

However, the choice of performance measures is one of the most critical challenges facing organizations. Poorly chosen performance measures routinely create the wrong signals for managers, leading to poor decisions and undesirable results. There are enormous hidden costs in misused performance measures. Shareholders pay the bill each day in the form of overinvestment and acquisitions that do not pay off, etc. It is not that management is poor. Simply, it is the wrongly chosen performance measures, which in turn push management to take improper decisions.

An exploration of empirical literature reveals that the direct role of accounting information in debt contracts has not received much attention from accounting researchers, although it has developed significantly, particularly in private placements of debt and private lending agreements Sloan (2001).

Performance pricing, which involves linking the interest rate that is charged on debt to accounting-based measures of financial health, is a frequent practice in financial contracting.

However, there has been limited research on this explicit governance role of financial accounting information. Essentially, the diagrams below illustrate the steps to be taken for the analysis of financial accounting information such as capital structure ratios and financial performance indicators.

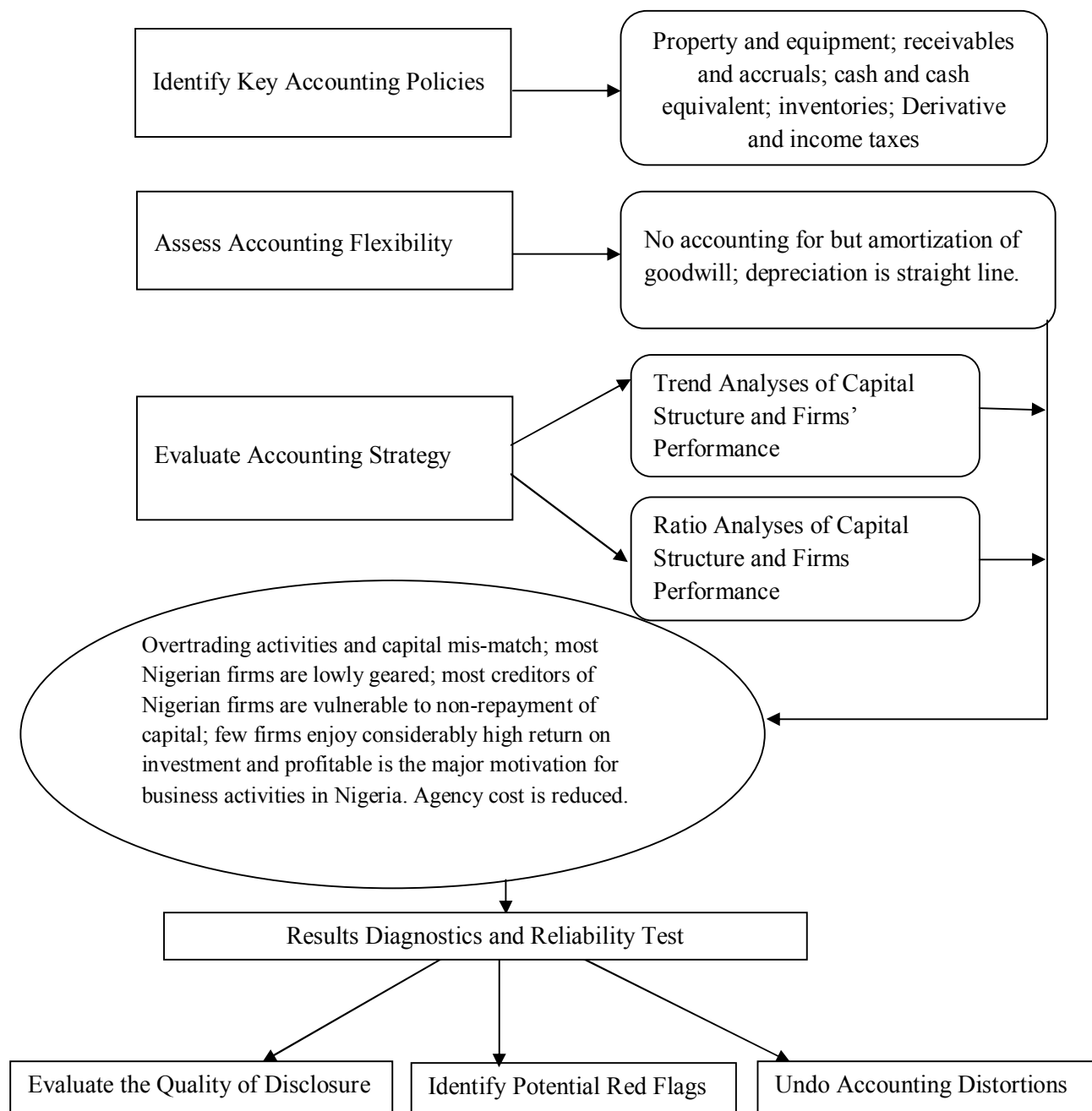


Fig. 1. Steps for Analyses of Capital Structure and Firms Performance

3. Discussion of Steps

Identify Key Accounting Policies. There are several different accounting policies to combine or shorten the accounting information; the first one is “Principal of Consolidation” which basically says that all intercompany balances and transactions have been eliminated. Some enterprises use what is called the “Use of Estimates” which could distort the numbers going on the financial statements. To derive the quantitative measures which consist of screening ratios which are to be used to assess the reliability of financial disclosures; as stipulated by the Generally Accepted Accounting Principles (GAAP); the Standard of Accounting Statements (SAS) and the International Financial Reporting Standards (IFRS).

Qualitative measures must be taken into account to fully evaluate the past accounting performances and successes of the Ukrainian enterprises sectors.

Key Accounting Policies. In order to measure the key success factors and risks pertained to enterprises sectors, it is necessary to evaluate the policies and estimates the enterprises use. Critical accounting policies are those that are most important to the portrayal of the enterprise's financial condition and the results of operations and require management's most difficult, subjective and complex judgments. The enterprise most critical accounting policies are: Revenue Recognition; Income Taxes; Net Accounts Receivable; Net Inventories; Cash and Cash Equivalents; Net Property and Equipment; Cost of Goods Sold; Shipping and Handling Costs; Net Goodwill and other Intangibles; Accrued Expenses; Derivatives; Stock Options, etc. Revenue Recognition is an important factor, along with Inventory accounts. Most firms are more focused on Inventory management as they are a retail company, whereas; goodwill and intangibles are not large factors in their financial statements.

Degree of Potential Accounting Flexibility. There are ways for enterprises to be Flexible in the Accounting Methods. But, by using the FIFO method to account for Inventory, it is hard to manipulate. Net Property and Equipment is made to be flexible because they use straight line depreciation, as opposed to the Double Declining method. Net Goodwill and intangibles is an area that is very flexible. There is no way to account for this asset, and they are not amortized, but only tested for impairment maybe annually.

4. Reliability Test of Accounting Analyses

Quality of Disclosure. Anchoring on the theory of Positive Accounting Theory; the following are relevant accounting standards – local and international – as observed by these firms that seek to guarantee the quality of financial disclosure of these firms and thus lend credence to the conclusion reached in our estimates.

Identify Potential Red Flags. In the financial records; there is a section categorized “Changes in and Disagreements with Accountants on Accounting and Financial Disclosure”. The explanation in this section by the enterprises was “Not applicable”. So therefore there were no changes. Considering the fact that all the enterprises are well established company and they pride their selves with their critical accounting principles. There have not been any recent changes or cause for concern or Red Flags. There have been increases in accounts payable that is due to the payoff of short and long term debt. The other increases are all minimal increases and follow the growth of the company.

Undo Accounting Distortions. After reviewing all pertinent financial data of the firms, one can conclude that the financial reports display transparency in the quality of disclosure. The company does a very good job as the extensive explanation of the increases and decreases that offset each other. There was no indication of misleading activity within the financial reports. The statement of cash flows was concurrent with the disclosures in the footnotes. The Critical accounting policies were apparent in the financial statements of the enterprises, and there was no distortion to enhance the true performance of the enterprises. All methods of accounting were clearly explained in the footnotes to the financial statements. Considering no accounting distortions were revealed, there is no need for any adjustments or corrections to the financial statements.

5. Conclusion

If the goal of company sustainability is to establish local economies that are economically viable, environmentally sound and socially responsible then it requires full participation from all stakeholders to determine needs and to identify and implement innovative and appropriate solutions. The quality of our examination was undertaken under three headings of quality of

disclosure, identification of potential red flags and undoing accounting distortions. Virtually all firms must observe the Generally Accepted Accounting Principles (GAAP) and also prepare their financial reports in accordance with the local and international accounting standards and the statement of accounting policies.

The present and future government as well as policy makers need to strengthen the enterprises by providing enabling environment for them as the role of government in the Ukrainian economy is still very huge and the effect of government policy on enterprise's performance and financing choices cannot be overlooked. The government would be able to re-examine the challenges that are impeding the enterprises to explore fully their financing options to achieve better performance for a sustainable development. The findings of our study will guide the government in the formulation and implementation of relevant policies that can ease these constraints especially the poor institutional quality and unfavourable macroeconomic environment.

References

1. Bushman R. Financial Accounting and corporate governance / R. Bushman, A. Smith // *Journal of Accounting and Economics*. – 2011. – Pp. 237–333.
2. Gupta P. Capital Structure and Financial Performance: Evidence from India / P. Gupta, A. Srivastata, D. Sharma. – Gautama Buddin University, Greater Noida, India, 2007.
3. Sloan R.G. Financial accounting and corporate governance: a discussion / R. G. Sloan // *Journal of Accounting & Economics*. – 2011. – Pp. 335–347.
4. Ungureanu M. Financial Analysis from an Accounting Point of View / M. Ungureanu // *CES Working Papers*. – 2013. – Pp. 138–148.

Summary

This paper examines the theoretical review of analysis of capital structure decisions of enterprises in an emerging economy of Ukraine. The capital structure of a firm consists of a particular combination of debt and equity issues to relieve potential pressures on its long-term financing.

This paper examined the steps undertaken for the analysis of financial accounting information such as capital structure ratios and financial performance indicators from financial report of an enterprise with the aim of discovering major determinants of its financial structure and also highlighted issues such as financial distress, bankruptcy threats, solvency problem, risk of default due to unstable economic and political situations as possible dangers that may plague the enterprises, whose capital structure may lean towards debt financing.

Keywords: Accounting, Ratio Analysis, Capital Structure and Firms' Performance.

JEL classification: M210

UD classification: 336.71:658.8

Date of acceptance: 20.10.2014.